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Appointing Independent Directors for Distressed Companies: An Alternative to Bankruptcy

The most traditional avenue for a distressed company seeking to reorganize existing debts or maximize company value is through a chapter 11 bankruptcy. However, due to its complexity, a chapter 11 bankruptcy can be a lengthy, expensive process that is not always palatable for the distressed company's secured lenders. In some situations, appointing an independent director or board of directors to replace the existing directors (consensually or non-consensually) is a quicker, more cost-effective turnaround approach. Independent directors can be beneficial for distressed companies because they (i) offer expertise as to maximizing value in a struggling business and (ii) insulate the company from liability related to any real or perceived conflicts of interest at the director level. For secured lenders, particularly when existing management is uncooperative or acting unreasonably, independent directors can offer a fresh and impartial perspective for the company, allowing for a unified path towards maximizing value. This article explores the mechanisms a secured lender can utilize when seeking to appoint independent directors, and key issues that secured lenders and independent directors alike should consider.

Mechanisms for Appointing Independent Directors

Independent directors can be appointed to take over a distressed company consensually or non-consensually.

- **Consensual path**: A distressed company will often seek to alleviate economic stressors by negotiating an amendment to its existing credit facility or entering into a forbearance agreement with its secured lenders. Secured lenders can utilize this opportunity to negotiate a condition precedent to the effectiveness of the applicable agreement that requires appointment of one or more independent directors (who are agreeable both to the secured lenders and to the company) by a date certain. This is the most desirable approach, as it promotes a unified path forward and is generally less risky and less costly.

- **Non-consensual path**: A typical secured financing will include an equity pledge and/or proxy right that allows secured lenders to exercise a shareholder's voting rights on the company's behalf upon the occurrence of an uncured event of default. When a distressed company has triggered an event of default under the existing loan facility and is not cooperating with its secured lenders, the secured lenders can choose to exercise their proxy rights to replace the existing directors with new independent directors who are better suited to act in the best interest of the company's stakeholders. This is generally considered the riskier approach, as it may result in litigation or disgruntled sponsors and company management that can undermine the new directors' efforts.

Fiduciary Duties of Independent Directors

The role of independent directors in a distressed company will vary based on the facts and circumstances of each company. Once independent directors have been appointed, however, they must comply with several fiduciary duties, including:

Duty to maximize value:

Directors of any company are obligated to maximize value for shareholders. However, in the case of distressed companies that may be insolvent, directors are obligated to maximize value for **all** stakeholders — including both the existing equity holders and the company's secured and unsecured creditors. Independent directors must therefore pursue the transactions that would maximize value for the company as a whole, irrespective of the impact on any particular subset of stakeholders.

Duty of independence:

One of the main benefits of appointing independent directors is that the new directors are free of any connection to the company's existing management team or equity holders. This permits unbiased decisions with respect to the company's goals and allows independent directors to engage in arms-length transactions with the company's insiders, if necessary. Independent directors have a duty to ensure that there is no conflict or appearance of conflict with the company's insiders and largest creditors in any value-maximizing transaction.

Considerations

Appointing new directors, particularly when done non-consensually, is atypical and is often viewed as an extreme remedy. It is important that secured lenders and independent directors alike consider a few key issues when deciding on their course of action.

Industry:

Understand the nature of the distressed company before deciding whether appointing independent directors would be value-maximizing. If the company is in a specialized industry, appointment of independent directors may not be beneficial unless the new directors have expertise in that industry. Consider whether offering roles to existing management who have intimate knowledge of the business may be necessary to effectuate a value-maximizing transaction.

Optimal path:

Understand the optimal path for the company to recoup value. If the company is in a dire financial position, asset foreclosure may be the only viable option such that independent directors may not be a worthwhile appointment. If the company is seeking to sell all or substantially all of its assets, consider whether potential buyers may prefer a sale by and through a bankruptcy filing that grants the assets to the buyer free and clear of all liens, claims, and encumbrances (which is not available outside of the bankruptcy process).

Litigious sponsor or equity holders:

Consider the secured lenders' relationship with the company's equity holders and sponsor (if applicable) prior to appointing any new directors. Depending on the situation, the sponsor may or may not be cooperative. It is likely that a sponsor has a majority of the board seats and losing control of the company could result in material and costly litigation if the sponsor chooses to challenge the independent directors' authority over the company. Affirmative steps may be necessary to thwart or mitigate litigation.

Insurance:

To the extent possible, review the company's existing insurance policies to confirm that coverage is sufficient to cover potential exposures occurring after the change of control — in particular, secured lenders should know whether a change of control will result in significant impact to, or termination of, any D&O policies. If coverage is insufficient, non-existent, or subject to termination, a new policy should be procured to protect the new directors prior to exercising the secured lenders' rights.

Salary/Indemnity:

Understand the independent directors' desired salary and related indemnity rights. Consider whether the company's current cash flow can support the new directors' salary requirements. Independent directors will request that the company indemnify the directors against any losses stemming from their appointment. Be prepared to negotiate indemnity provisions and tailor the provisions to the needs of the company and the particular directors.

Credit agreement and intercreditor provisions:

To avoid scrutiny when exercising a pledge or proxy right, secured lenders must exercise caution and confirm that (i) an indisputable event of default has occurred under the applicable credit documents and (ii) they are exercising their rights in strict accordance with the terms of the applicable credit documents, including all relevant voting and notice provisions. Before acting on an equity pledge, the agent of any secured facility should determine whether a required lender vote is necessary to effectuate the transaction and acquire the necessary votes, if applicable.

Other secured lenders:

Consider the reaction of the company's other secured lenders. Efforts should be made to gain the other secured lenders' consent to the new directors' appointment if possible. Otherwise, ensure that the appointment complies with existing intercreditor agreements, as they may impose additional requirements. The independent directors, once appointed, should confirm for the other secured lenders that all actions are being pursued for the benefit of all creditors, not just the most senior secured lender.

Other key constituencies:

Review the company's material contracts to determine if the board flip would trigger any change-of-control provisions and, if so, the impact on the company's business. Additionally, the new directors should have a plan for go-forward communications with employees, key customers, suppliers and/or regulators.

Organizational structure:

To maximize the authority of the independent directors, thoroughly analyze the company's organizational structure and operational documents. There is likely to be an optimal entry point in the organizational structure that will bind all operational entities to the decisions of the new directors. It is unlikely, however, that any equity pledge would cover the equity owned by a sponsor in the ultimate parent company. As a result, the ultimate parent may not be bound by the organizational decisions of the independent directors. Consider whether the sponsor is likely to be uncooperative. It is also worth considering whether any existing directors or managers of the company's subsidiaries must be replaced in accordance with the organizational documents in order to ensure that the independent directors have decisional authority over the subsidiaries.

Compliance with fiduciary duties:

Independent directors should understand their fiduciary duties once appointed. It is important to maintain independence such that all transactions executed by the company, particularly those involving insiders or the secured lenders, will not be later analyzed by a bankruptcy court or creditors' committee under a heightened standard of scrutiny. Be forewarned that the new directors may be challenged as lacking independence if they have been appointed as directors in past transactions involving the same secured lenders. New directors must distance themselves from the secured lenders and safeguard against perceptions that decisions are being made for their sole benefit. For Delaware LLCs, it is becoming common practice for a director's fiduciary duties to be waived in the company operating agreement. In such scenarios, strict compliance measures are not the dominant concern.

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